Donald W. Boecke
for Rochester Telephone Corporation
100 Midtown Plaza
Rochester, New York 14646

Josephine S. Trubek, Esq.
Helen Zamboni, Esq.
for Rochester Telephone Mobile Communications, and RCI Corporation
100 Midtown Plaza
Rochester, New York 14646

Jack R. Lebowitz, Esq.
Miller, Mannix, Lemery & Pratt, P.C.
for United States Transmission Systems, Inc., American Mobile Communications, Inc., Cellcom Telephone Company, and Nationwide Cellular Services, Inc.
Northway Plaza, P.O. Box 3300
Glens Falls, New York 12801

Robert L. Sills, Esq.
Deborah A. DuPont, Esq.
Reboul, MacMurray, Hewitt, Maynard & Kristol
for U.S. Sprint Communications Company
45 Rockefeller Plaza
New York, New York 10020

Stephen P. Bowen, Esq.
for U.S. Sprint Communications Company
1850 M Street, N.W. - 11th Floor
Washington, D.C. 20036

Daniel W. Rosenblum, Esq.
Ashok Gupta
Public Utility Law Project
for Universal Service Alliance
2090 Seventh Avenue, Suite 2000
New York, New York 10027

Randolph J. May
Bishop, Cook, Purcell & Reynolds
for User Parties
1400 L Street, N.W.
Washington, D.C. 20005

Robert J. Cimino, Esq.
for County of Suffolk
Building 158, North County Complex
Veterans Memorial Highway
Hauppauge, New York 11788

Glenn Richards, Esq.
for New York City Energy and Telecommunications Office
49 Chambers Street, Room 720
New York, New York 10007

Keith J. Roland, Esq.
Roland & Fogel
for Empire Association of Long Distance Telephone Users
1 Columbia Place
Albany, New York 12207

Richard H. Wagner, Esq.
Colin Grannum, Esq.
Gerald Oscar, Esq.
for New York Telephone Company
1095 Avenue of the Americas
New York, New York 10036

Kathleen Quinn Abernathy, Esq.
Ellen S. Deutsch, Esq.
Thelen, Marrin, Johnson & Bridges
for Taconic Telephone Corporation
2300 N Street, N.W.
Washington, D.C. 20037

James V. Troup, Esq.
Ellen S. Deutsch, Esq.
Kadison, Pfaelzer, Woodard, Quinn & Rossi
for Taconic Telephone Corporation
2000 Pennsylvania Avenue, Suite 7500
Washington, D.C. 20006

Philip S. Shapiro, Esq.
for NYS Consumer Protection Board
99 Washington Avenue
Albany, New York 12210

Kathleen Hawkins Berkowe, Esq.
for Rockefeller Center Telecommunications
1230 Avenue of the Americas
New York, New York

Hal Lubow
for AMCOM
600 Meadowland Parkway
Secaucus, New Jersey 17094

Matt Edwards
for Unicell, Inc.
177 East 87th Street, Suite 401
New York, New York 10128

Diana Forrest
for Cellcom Telephone Company
34-36 Fornelius Avenue
Clifton, New Jersey 07012

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

COMMISSIONERS:

Peter Bradford, Chairman
Harold A. Jerry, Jr.
Gail Garfield Schwartz, concurring
Eli M. Noam, concurring
James T. McFarland
Edward M. Kresky
Henry G. Williams

CASE 29469 - Proceeding on Motion of the Commission to Review Regulatory Policies for Segments of the Telecommunications Industry Subject to Competition.

OPINION NO. 89-12

OPINION AND ORDER CONCERNING
REGULATORY RESPONSE TO COMPETITION

(Issued and Effective May 16, 1989)

BY THE COMMISSION:

PROCEDURAL BACKGROUND

In light of the emergence of competition in some segments of the telecommunications industry, we instituted this case to review our regulatory policies. Our staff had reported recent substantial expansion in the number of firms operating in the toll, private line, and cellular markets and that each of those markets was exhibiting competitive

characteristics. We therefore convened a formal proceeding[1] "to determine the degree to which effective competition currently exists within each of [those] markets and among the various companies operating in [those] markets."

The proceeding was conducted in two stages, with Administrative Law Judge J. Michael Harrison presiding. The first stage provided for the development of an analytical framework for defining and measuring the extent of competition and adduced evidence concerning that issue. The second stage provided for the development of regulatory policy issues raised in our initiating order, and was handled "on the papers as part of the post hearing briefs." Hearings were held in May, June, September, and October 1987, at which 30 witnesses testified on behalf of 20 parties. The record comprises 3,331 pages of testimony and 141 exhibits.

Judge Harrison's recommended decision was issued on May 9, 1988. The Judge analyzed each segment of the telecommunications market and recommended, on the basis of his analyses, varying degrees of regulation. He proposed that the present regulatory scheme be retained for the intra-LATA market, but otherwise generally endorsed staff's proposal to streamline regulation, finding that regulation

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[1] Case 29469, Order Instituting Formal Proceedings (adopted at the session of October 22, 1986).

could be made less burdensome in some instances. He noted as well that the record could have benefited from certain kinds of information, such as cost studies, but that it nevertheless revealed the broad outlines of market conditions. Parties filing briefs to the Commission concerning the Judge's recommendations are listed in Appendix A.

## INTRODUCTION

The public interest is generally furthered by the emergence of competition wherever possible and prudent. The transition from regulation to competition is a critical challenge confronting utility regulators at this time. Done wisely, it offers potentially lower prices, higher service quality, broader consumer choice, more efficient industries, higher productivity, and a stimulus to economic growth, especially in the information-intensive service industries that provide the economic backbone of the New York economy.

Done too rapidly or with insufficient safeguards, it could lead to unregulated monopoly, price shocks, ratepayer subsidies for unregulated enterprises, and declines in service quality. Done too slowly, it will foster high prices, impede new service offerings, stagnate markets, and weaken the economy.

In most of the major regulated monopoly industries, this transition is underway. However, in the telecommunications sector--where the technology itself has changed fundamentally in often procompetitive ways--the pace has been especially fast. Since the breaking of the AT&T near-monopoly over telephone terminal equipment interconnection, the choices and prices in that market segment have improved immeasurably, and the forecasted evils (such as technical harm to the network) have not occurred.

The opening of the market for carrying calls is more complex than the opening of the market for customer premises equipment, but the potential customer benefit is still great. Because much of the benefit of transport competition occurs in the first instance to large volume users and has the potential to reduce existing residential subsidies, the introduction of competition that may eliminate the source of the subsidy is controversial, but it is conditioned by two important factors.

First, the existing technology allows the largest users to construct private systems. Attempts to deny the benefits of competitive pricing to these users can only encourage them to drop off the system altogether, which would increase prices to everyone else.

Second, existing residential subsidies went, before the Commission's lifeline program, to all customers, not just to those who needed them. The wealthiest residential customer received the same subsidy as a member of the middle class or the poorest customer. Realigning the subsidy dollars within the residential class so that they flow to those who need them reduces the negative effects of competition on low income customers.[1]

Six other basic principles will assure consumer protection while maximizing competitive benefits. We will move toward competition as rapidly as possible as long as--but only as long as--they are carefully observed:

1) Our commitment to universal affordable telephone service for all New Yorkers is undiminished.

2) High service quality must be maintained.

3) An adequate forum for resolving consumer concerns must continue to exist.

4) Rate shock to individual customer classes or groups must be avoided.

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[1] Cases 28961, et al., Lifeline Rates, Opinion No. 85-12 (issued May 9, 1985).

5) Deregulation is not to be the first step toward unregulated monopoly or near monopoly.

6) The ability to reregulate if any of the above conditions are not met must be maintained.

Emerging competition requires altered regulation. Some of the changes may be accomplished administratively; others require revisions to the Public Service Law. To that end, we will propose legislation that would largely deregulate competitive providers or services and permit us to deregulate other providers or services upon a finding that they are competitive. At the same time, the statute permits reregulation of deregulated services or providers when necessary, and allows us to ensure that customer satisfaction is maintained at a reasonable level. We must continue to

-- encourage competition to the extent consistent with the maintenance of universal service;

-- monitor the status of the competitive telecommunications market and the quality of its service;

-- monitor market conditions to determine which companies are nondominant;

-- monitor price trends to insure that deregulation generates neither predation nor anti-competitive cross-subsidies;

-- establish service requirements to insure access to emergency service;

-- determine customer satisfaction with the quality of competitive services;

-- insure that the quality of basic service does not diminish;

-- insure that those services defined as basic continue to be provided at rates that are reasonable;

-- insure that adequate complaint resolution mechanisms exist, either through department staff to the extent services continue to be provided pursuant to tariff or Commission-approved contract, or through the service providers themselves in the case of deregulated services; and

-- obtain from companies any information necessary to make the foregoing determinations.

## CELLULAR TELEPHONE SERVICE

Cellular telephone services, which use radio frequencies, are provided under a market structure determined by federal, rather than state, agencies. The Federal Communications Commission (FCC) licenses up to two carriers (one associated with the local exchange company and one not so associated) to provide cellular service in a given cellular geographic service area. The FCC has established 17 cellular service areas in the state: 11 metropolitan service areas and six rural service areas. All metropolitan areas are served by two competing carriers. The FCC has yet to authorize operators for the rural areas. Resellers are also permitted to purchase bulk capacity from licensed carriers for repackaging and resale to the public.

Since these carriers provide services that are not now considered essential to most telephone users, and since there are or will be at least two competitors in each territory in which the service is provided, we do not regulate them extensively. Although carriers must be certified, must file tariffs and must report financial information, the processes have been simplified. Our complaint jurisdication extends to ordering resolution of disputes, although, as with any other tariffed service, we encourage carriers to make efforts to resolve complaints on their own.

In this case, the cellular telephone companies associated with local exchange telephone companies (Rochester Mobile and NYNEX Mobile) argued for the deregulation of cellular service; arguments also were made by other parties for more or less regulation than now exists.

Judge Harrison determined that if the service were considered a non-essential luxury, deregulation would be appropriate. Alternatively, if the service were essential, he would recommend a staff proposal that regulatory requirements be streamlined to the extent possible.

If the service is furnished competitively, we need not decide whether it is a luxury. We conclude that the service is furnished competitively, for the market structure is one that has been designed by the FCC to be competitive. Additionally, the existence of resellers--compounded by the existence of significant excess capacity--operates to check monopoly abuses of the facilities-based carriers and reduce the potential for a duopoly. Our experience, which shows that these carriers do not need to be regulated, as well as that of more than half the states, which have deregulated or vastly reduced regulation of cellular service, also supports our conclusion that this market is competitive.

We therefore will seek legislation that suspends the application of most aspects of the Public Service Law, including certification and rate regulation, to the provision

of cellular service. The Legislature took such action with respect to one-way paging and two-way mobile communication services in 1984, similar action is justified here.[1]

The legislation would authorize us to monitor market conditions to insure that the basic principles discussed above will be satisfied.[2] Our proposal would exempt cellular telephone service from Articles V and VI of the Public Service Law but would establish minimal registration, service and reporting requirements. It would also provide that we could reinstitute regulation if necessary. We would retain authority to obtain from the company market information involving market share, number of providers, price levels, such other indices of competition that we shall specify, and such other service and rate information that we feel is necessary. We will direct our staff to develop requirements for periodic reports that are designed to provide this information.

As for our consumer protection function, we no longer would act as the customer's forum of last resort for resolution of complaints. Rather, our job would be to insure

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[1] The statute is codified at §5(3) of the Public Service Law.

[2] For example, if licensed cellular companies engage in price squeezing tactics to eliminate or disadvantage cellular resellers, we will consider regulating them again to the extent necessary to maintain a competitive market.

that the companies are making adequate complaint resolution mechanisms available and are taking steps necessary to provide customers with sufficient information to make informed choices about their service options.

Pending action on our legislative proposal, we shall not alter the manner in which cellular telephone service is regulated. We shall require that a local exchange company that provides cellular service do so through a separate subsidiary.[1] Although we usually rely on cost accounting procedures to protect against outsiders when regulated and non-regulated services are provided by the same business, it is more effective to simply separate the businesses. Because cellular service is provided over a network that is physically independent of landline telephone facilities, that approach--which is not practicable in instances where both services use the landline network--is the one we shall use here.

## RESELLERS

The resale of telephone services occurs when a firm orders services from a regulated supplier and repackages those services in a way that provides consumers benefits of

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[1] The FCC has required Bell Operating Companies that provide cellular service to do so through a separate subsidiary.

pricing and/or additional service and feature availability.[1] Resellers can exist due to the differential between the wholesale and retail rates of facilities-based carriers or because this service offers advantages not available from the wholesaler. They operate in a number of telecommunications markets. Cellular resellers, for example, can buy up blocks of cellular capacity and resell them to end users. Resellers have no telecommunications facilities themselves,[2] and are most often entities that sell and install the cellular instruments (such as automobile dealers). The FCC has allowed only two facilities-based cellular carriers in each service area and has therefore required cellular telephone carriers to offer non-discriminatory resale of their services to facilitate the development of a resale market.

A reseller of toll services buys service from a facilities-based carrier and supplies service on a retail basis to its own customers. Frequently, such resellers also employ network equipment to switch or transport traffic and

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[1] All telephone corporations engage in resale to some extent; however, some of these firms provide no regulated telecommunications services other than the resold services. The term reseller, when used in this Opinion, refers to the latter circumstance. This serves to distinguish these firms from other non-dominant carriers that may also engage in resale activity to a certain extent.

[2] A company operating as a reseller in one area could be a facilities-based carrier in another.

so take on, to some extent, the attributes of a facilities-based carrier. These resellers tend to enhance the competitiveness of toll markets.

A variant of toll resale has come to be known as alternative operator services (AOS). These providers resell long distance service for operator assisted calls. They package the resale of toll with the operator assistance function, which they provide themselves. These firms contract with institutions, such as hotels and hospitals, where large volumes of demand for operator assisted calls are concentrated. The fundamental service AOS providers offer these institutions is their capability for remote billing. Of course, dominant regulated carriers also have this capability. Where a hotel or a hospital has a contract with an AOS provider to carry all its operator assisted traffic, the hotel's customers or hospital's patients have no alternative means (or perhaps only a poorly described and inconvenient one) of carrier selection. These captive users are thus vulnerable to high rates and poor service.

Two other special resale situations also involve potential bottlenecks which require special attention. These involve the provision of customer owned, coin operated telephones (COCOTs) and the provision of shared tenant service (STS). The latter service results, for example, when the owner of a building directly or through a service

operator provides switching equipment and some telephone service--such as inter-tenant calling and direct connection to interexchange--to the tenants without necessarily using the facilities of the local exchange company.

Resellers (except for COCOTs) are required to be certified and to file tariffs. They are subject to our resolution of customer disputes as well as limited financial reporting and accounting rules. In this proceeding, resellers sought to have their services at least detariffed, and preferably deregulated.

Judge Harrison concluded that the level of regulation of telephone resellers could be significantly reduced. He reasoned that because resellers cannot influence the wholesale price of the service they resell, regulation has little role to play.

With the noted exceptions, resale activity tends to exhibit the characteristics of effective competition and tends to foster competition in the markets in which resellers participate. There are no significant, effective barriers to entry and resellers generally do not have the ability to control prices or exercise market power. Accordingly, we will propose legislation for resellers similar to that being proposed for cellular service. However, because of the potential for market failure, the legislation will provide

for minimum service, rate, and interconnection requirements for AOS, COCOTs and STS.

Pending adoption of the legislation, we will continue light regulation of most resellers (e.g., we will continue to certify new carriers and require tariff filings and will continue to apply certain minimum service requirements). We will also continue our complaint resolution function as long as these services continue to be provided pursuant to tariff. Cellular resellers enhance the competitiveness of that market; and it must be clear that the facilities-based carriers should treat all competitors--including their subsidiaries--equally. We are also concerned that regulated companies not use resale to avoid their underlying common carrier obligation.

The exceptions to these interim arrangements occur where a reseller can constitute a bottleneck. Such bottlenecks can be harmful because they may create market power that can result in non-market based decisions on pricing, quality, and content or user discrimination. COCOTs and alternative operator services are two instances where resellers may wield significant market power. We are concerned about the impact on consumers who use these services and we have recently established a proceeding that

will consider the resale of service through COCOTs,[1] and another proceeding is evaluating alternative operator services.[2] We shall retain authority to deal with such problems if and when they occur.

Shared tenant services providers may also become bottlenecks. Those providers resell, in effect, both local and toll service, and could prevent or substantially deter a tenant from obtaining service from other providers, such as the local exchange company. Accordingly, our legislative proposal would require STS providers to permit reasonable access to the services of the local exchange company and interexchange carriers for tenants who desire service directly from that company and interexchange carriers. STS providers must permit exchange company access to their intra-building facilities at fair and reasonable rates.

## INTER-LATA SERVICES

### Other Common Carriers

The record in this proceeding shows that the other common carriers (OCCs)--carriers other than ATTCOM, such as MCI and Sprint--exert little market power. In the inter-LATA

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[1] Case 27946, Order (issued February 22, 1989).

[2] Case 88-C-102.

market, for example, they had 11% of the revenues and 14% of the subscribers in 1986, the latest year for which the record contained data. These proportions represent a significant increase from the period immediately following divestiture, and the trend of this increasing share should continue. While the OCCs' aggregate share is steadily increasing, it will be spread among a greater number of competing entities. An individual company's market share--and, hence, market power--is unlikely to increase significantly.

We currently exercise only limited regulation of the OCCs. They are required to be certified, and to file tariffs, but are subjected to minimal service quality and financial reporting standards as well as our complaint jurisdiction. In this case, staff proposed further loosening of the regulation of these firms and Judge Harrison recommends staff's proposals.

Given the status of the market, we will continue the light regulation of the non-dominant OCCs. Reporting requirements, however, will be reduced by requiring only basic financial statements, market share information, and the tabulation of complaints.

Our legislative proposal for these companies will be similar to those discussed above for the cellular and reseller market segments.

ATTCOM

ATTCOM is currently subject to the full panoply of regulation;[1] Judge Harrison recommends that because of its market share it continue to be so regulated.

The OCCs have relatively little market power as evidenced by their individually small market shares; conversely, ATTCOM continues to have substantial, though steadily declining, market power in the inter-LATA market. It has earned high profits in recent years while controlling, in the period immediately following divestiture, up to 90% of the New York inter-LATA market. (The existence of high profits immediately after divestiture is, of course, not dispositive of market power. These profits, in any event, may have been more attributable to uncertain access costs than to monopoly power.) Moreover, ATTCOM's national market share is declining, and there is no reason to expect a different result in New York. Still, given its dominant position, continued regulation, at least for a transition period, is advisable for ATTCOM's provision of inter-LATA service. Therefore, regulation of ATTCOM shall not now be relaxed to the extent that it is being relaxed for the other long distance companies.

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[1] ATTCOM has agreed to a rate moratorium and has some pricing flexibility. It is also permitted to retain half of any profits it achieves over its target earnings, as an incentive to efficiency.

Additional pricing flexibility, however, is justified, especially in ATTCOM's more competitive services. Thus, for the two and one half year period after the current rate moratorium (until January 1, 1992), ATTCOM shall be offered as an alternative to traditional rate base regulation, an incentive regulation plan. The plan would freeze ATTCOM's message toll service prices[1] at current levels as a price ceiling and provide for substantial pricing flexibility for its other, more competitive services. That flexibility will be subject to two constraints; that no rate element be increased by more than 25% per year and that the annual revenue increase from price increases, without hearings, be limited to 2.5%. (This latter limitation is required by the Public Service Law.) We would also allow for the rapid introduction of new services without prior analysis of cost support and provide that changes in access charges, separations, and any regulatory costs imposed due to regulatory requirements be flowed through to customers. Similarly, we would provide that the effects of federal, state, or local tax law changes would also be flowed through to customers. ATTCOM would be required to continue to offer

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[1] Including, among others, MTS, Cross State Service, directory assistance, and operator services. We intend to review at the plans' inception those prices to insure that they result in a reasonable return for ATTCOM.

universal service at geographically averaged prices[1] and, over the period, to share equally with ratepayers earnings in excess of a predetermined level. The sharing level will be determined after receipt of comments on an ATTCOM filing implementing this proposal.[2]

In the longer run, we intend to deregulate ATTCOM. Its market share is likely to decline further, and it has made a reasonable case that it is subject to increasingly significant competition. Competitive pressures are likely to grow as more customers get equal access and ATTCOM's competitors mature. We conclude, therefore, that unless there is a material change in circumstances, ATTCOM should be deregulated by January 1, 1992. We shall seek legislation to accomplish that end. The legislative authority we plan to seek now would permit us to provide ATTCOM with full pricing flexibility starting in 1992 and make the treatment of ATTCOM symmetric with that of the OCCs. Any deregulation proposal would emphatically confirm ATTCOM's universal service and nondiscriminatory common carrier obligations, would include

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[1] We recognize that our decision in the access charge case contemplates the deaveraging of interexchange carrier access charges, if the cost studies to be performed by the local exchange companies so warrant. That action, in turn, may require ATTCOM to deaverage its intrastate toll rates.

[2] The plan is outlined in Appendix B.

the consumer protection monitoring procedures discussed earlier, and would provide us with authority to reregulate.

## INTRA-LATA SERVICES

### Introduction

The issues considered in this section cover a broad range, from residential access lines to a variety of business services. The status of competition varies in each market as well. As we explain in each of the subsections that follow, we will tailor regulation to fit the competitive characteristics of each market. As a general matter, competition is more advanced downstate, and a greater degree of deregulation is warranted there. When and if competition emerges upstate, we will be receptive to proposals for similar deregulation.

One problem, resulting from the way certain services have traditionally been priced, involves several services and thus bears discussion at the outset. As various services of dominant carriers become competitive, the market drives prices to cost, and the contribution made by those services in support of basic service diminishes. We will carefully monitor this situation in order to mitigate adverse impacts on ratepayers.

As part of that review, we will attempt to spread fairly the costs of local exchange service, in order to avoid having that burden borne solely by the local exchange companies. Where interconnectors, such as Teleport, receive new rights, it may be reasonable to require that they bear some new burdens. Moreover, we anticipate that technology and competition will drive costs down and therefore address concerns in this area.

Dedicated Switching

Centrex services provided by the local exchange company involve customized central office switching that provides the business customer with station-to-station intercom-like service and special features. Alternatively, a customer may purchase, from a non-regulated company, a Private Branch Exchange (PBX), which provides for switching between stations on the customer's premises. PBXs must be linked to the public network via trunk lines, so local exchange company control of those lines could provide monopoly power.

In this case, New York Telephone presented evidence concerning the competitiveness of Centrex and sought additional pricing flexibility for that service. Judge Harrison determined that while PBXs are a thriving alternative to Centrex, New York Telephone still possessed